BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS
Jeff Hatch-Miller, Chairman
Marc Spitzer
William A. Mundell
Mike Gleason
Kristin K. Mayes

IN THE MATTER OF QWEST CORPORATION'S FILING OF RENEWED PRICE REGULATION PLAN	Docket No. T-01051B-03-0454
IN THE MATTER OF THE INVESTIGATION OF THE COST OF TELECOMMUNICATIONS ACCESS.	Docket No. T-00000D-00-0672

NOTICE OF FILING SURREBUTTAL TESTIMONY OF F. WAYNE LAFFERTY

Please take notice that Cox Arizona Telcom, LLC is filing the Public Version of the Surrebuttal Testimony of F. Wayne Lafferty, a copy of which is attached. A Confidential Version of the testimony will be provided to those parties who have agreed to be bound by the Protective Order in this docket or as otherwise required by the July 23, 2004 Procedural Order in this docket.

Pursuant to the July 23, 2004 Procedural Order in this docket, Cox Arizona Telcom, LLC states that certain confidential information has been redacted from the Public Version of the Surrebuttal Testimony of F. Wayne Lafferty. The redacted information is information that has been designated by Qwest as "Confidential" or "Highly Confidential" pursuant to the Protective Order and consists of:

1. Information concerning specific numbers of Qwest Arizona customers and the types of services they receive; and

2. Information concerning Qwest customer general calling patterns.

RESPECTFULLY submitted this 12th day of January, 2005.

COX ARIZONA TELCOM, LLC

By ______________________

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COPIES of the foregoing hand-delivered/mailed this 12th day of January, 2005, to:

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IN THE MATTER OF QWEST CORPORATION'S FILING OF A RENEWED PRICE REGULATION PLAN	) DOCKET NO. T-01051B-03-0454
IN THE MATTER OF THE INVESTIGATION OF THE COST OF TELECOMMUNICATIONS ACCESS	) DOCKET NO. T-00000D-00-0672

SURREBUTTAL TESTIMONY

OF

F. WAYNE LAFFERTY

ON BEHALF OF

COX ARIZONA TELCOM, L.L.C.

January 12, 2005

(PUBLIC VERSION)

TABLE OF CONTENTS

A. IDENTIFICATION AND QUALIFICATION OF WITNESS

Q. What is your name and business address?

A. My name is F. Wayne Lafferty and my business address is 2940 Cedar Ridge Drive, McKinney, Texas 75070.

Q. By whom are you employed?

A. I am a Director of the Barrington-Wellesley Group, a full service management consulting firm serving the telecommunications and public utility industries.

Q. Mr. Lafferty, on whose behalf are you testifying in this proceeding?

A. My testimony is presented on behalf of Cox Arizona Telcom, L.L.C., which is a facilities-based provider of local telecommunications services in Arizona.

Q. Are you the same F. Wayne Lafferty who filed Direct Testimony in this proceeding?

A. Yes

B. PURPOSE OF SURREBUTTAL TESTIMONY

Q. Mr. Lafferty, what is the purpose of your Surrebuttal Testimony?

A. My surrebuttal testimony provides the Arizona Corporation Commission ("Commission") with a response to some of the issues raised in the rebuttal testimonies of several of the Qwest Witnesses as well as comments on a few of the issues in the direct testimonies of some of the Staff testimony in this proceeding. Specifically my testimony addresses the responses of the Qwest witnesses to the concerns and recommendations I outlined in my direct testimony related to: (i) the level of competition and Qwest's market power in Arizona; (ii) Qwest's competitive zone proposal; and (iii) Qwest's Arizona Universal

Service Fund ("AUSF") proposal. In addition, I comment on a few of the recommendations regarding Qwest's competitive zone proposal made by the Staff.

C. SUMMARY OF TESTIMONY

Q. Please provide a summary of your Direct Testimony.

A. Qwest Witness Teitzel continues to significantly overstate the threat to Qwest from competition. As expected, the FCC has eliminated competitive LEC access to unbundled switching and the unbundled network platform ("UNE-P") and increased the prices for many of the remaining customers. While Qwest offers an alternative commercial product, the cost to competitive LECs is higher, making the margins negative for competitors in most instances. Recent data published by the FCC indicates that competitive LEC access line and market share growth has slowed significantly since the FCC announced the potential elimination of unbundled switching.

Qwest has provided no real evidence to dispute Cox's position that wireless and VoIP are not comparable alternatives to basic wireline telephone service. Qwest's efforts to convince the Commission that wireless is a substitute have no merit, and the FCC has recently reconfirmed its conclusion that wireless is not replacing wireline service in any significant way. Wireless cannot be considered comparable to wireline service, especially for customers choosing just basic local residential service. The Staff has confirmed Cox's position that VoIP is in its infancy and does not offer a significant threat to Qwest. In addition, Mr. Teitzel mischaracterizes Cox's suggestion that DSL is the main reason Qwest's access line count has decreased. DSL service has replaced some traditional switched access lines, but it is one of many factors changing the nature of a telephone company's revenues.

Mr. Teitzel's suggestion that shifting customers from retail to wholesale service solely results in significant negative revenue implications is unsupported. He does not include the expense reduction implications, nor does he provide any support for the percentage of revenue lost when a retail customer becomes served using wholesale network elements. Data presented by RUCO Witness Johnson actually suggests that Regional Bell Operating Company ("RBOC") costs have declined faster than their prices since the 1996 Act was passed.

Qwest has not provided any new evidence that its competitive zone proposal should be accepted by the Commission at this time. Cox supports Staff's recommendation that all of the issues regarding competitive zones be handled in a separate dedicated proceeding so that the Commission can adequately address the required competitive safeguards on a more generic basis. Qwest admits rate de-averaging is a likely result of the competitive zone proposal; however, Qwest understates the degree to which rates will likely vary both within a zone and across the state. The bottom line is that wide spread rate de-averaging could easily result under Qwest's plan. The Staff confirms Cox's position that establishing competitive zones on a wire center basis would not be appropriate for customers. Mr. Teitzel suggests the threat of competitive re-entry would restrict any predatory pricing; however, he fails to acknowledge the high fixed cost of entry that would be hard for potential competitive LECs to overcome, especially ones that had previously been predatorily priced out of the market. Even if a competitive LEC already had facilities in the market, the transaction costs of market entry discussed by Dr. Johnson on pages 119 and 120 of his direct testimony would pose a barrier. Moreover, re-entering CLECs would have to overcome the stigma of their initial exit from the market. In addition, the sustainability of high transaction costs and the implications for poor competitive LEC margins would discourage re-entry.

Both Qwest and Staff fail to reflect the need to better align the Commission's imputation test with the nature of the competitive market. As long as UNEs continue to be an important source of competitive entry, Qwest's retail prices for competitive service and bundles which include any competitive services must cover, at a minimum, the sum of the prices of the unbundled network elements that are utilized to provision the service plus the long-run incremental cost of any other required network functions for all competitive services. Staff also correctly determines that Qwest's competitive zone proposal would result in circumstances where Qwest had more pricing and regulatory flexibility than competitive LECs. This gap must be eliminated. Clearly, Staff is correct that further analysis of Qwest's competitive zone proposals is required.

Mr. Teitzel's dismissal of Cox's proposal to reform the contribution mechanism for the Arizona Universal Service Fund ("AUSF") is misguided. On the one hand, Qwest proposes a 77-fold increase in the fund. On the other hand, Qwest proposes the existing contribution mechanism, which raises the over $64 million required to meet Qwest's proposed draw from the AUSF, does not need to be reviewed. Given the magnitude of AUSF money requested by Qwest, the entire AUSF should be reviewed.

Qwest Witness Million appears to confuse Cox's concerns with the use of TSLRIC as a price floor with the actual calculation of the TSLRIC costs. While Ms. Million's testimony suggests Qwest's TSLRIC studies are not completely based on the proper UNE costing methodology, Cox is not concerned with the amount of the resulting costs at this time. However, as already discussed, Qwest's proposal to use TSLRIC as a price floor is inappropriate to remove the threat of a retail – wholesale price squeeze.

D. RESPONSE TO QWEST WITNESS DAVID L. TEITZEL CONCERNING THE LEVEL OF COMPETITION

Q. Mr. Teitzel claims all the evidence in the marketplace suggests competition is growing significantly. Are you aware of any recent evidence which shows the growth of competition may be slowing?

A. Yes. In my direct testimony I cite several serious obstacles to the outlook for real competition for Qwest's wireline service. In addition, some more recent information is available which reinforces the fragile state of competition in Arizona. On December 22, 2004 the FCC issued a report providing data concerning the level of competition as of June 30, 2004 ("December 2004 Local Competition Report")[1]. Based on the information presented by the FCC, the growth of competitive LEC access lines in Arizona for the six months ended June 30, 2004 was less than half the level for the prior year. Over the same period the growth in competitive LEC market share also decreased by over 50% from the prior year. Interestingly, the rate of reduction in the number of incumbent LEC access lines in Arizona for the same period also decreased. These trends confirm the concerns I raised in my direct testimony.

Q. Are you aware of any factors which might have contributed to this steep decline?

A. Yes. As I mentioned in my direct testimony there has been a high degree of uncertainty regarding the future availability of certain unbundled network elements ("UNEs"), especially unbundled switching and the UNE-P which includes switching. Since the Triennial Review Order ("TRO")[2] and the resulting DC Circuit Order[3] were issued, the

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[1] See *Federal Communications Commission Releases Data on Local Telephone Competition*, December 22, 2004 (hereinafter referred to as the December 2004 Local Competition Report").

[2] See *In the Matter of Unbundled Access to Network Elements,* WC Docket No. 04-313, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket No. 01-338, Order and Notice of Proposed Rulemaking, FCC-04-179, ¶ 1 (rel. August 20, 2004) (hereinafter referred to as the "TRO").

[3] See *U.S. Telecom Ass'n v. FCC*, 359 F.3d 554 (D.C. Cir. 2004) (hereinafter referred to as the "DC Circuit Order").

industry has not had firm regulatory guidance regarding the availability or pricing for these elements. Speculation by carriers and investors has been that unbundled switching and the UNE-P would at a minimum cost significantly more and possibly be eliminated entirely. On December 15, 2004, the FCC determined that "Incumbent LECs have no obligation to provide competitive LECs with unbundled access to mass market local circuit switching."[4] The FCC "adopted a twelve month transition plan for competing carriers to transition away from use of unbundled mass market local circuit switching."[5] Furthermore, the FCC's decision prohibited competitive LECs from adding new UNE switching (or UNE-P) customers and set higher rates for remaining UNEs during the transition period.[6] Therefore, as expected the UNE-P has been eliminated and any new alternatives will be more expensive at the least.

Q. Do competitive LECs rely heavily on the UNE-P to serve customers?

A. Yes. On a national basis 80% of the access lines served by competitors using UNEs were based on purchase of the UNE-P or UNE switching.[7] By applying this percentage to the total number of competitive LEC access lines in Arizona which were provisioned using UNEs (267,651)[8], one can calculate that approximately 214,121 competitive LEC access lines require the UNE-P or UNE switching. These access lines represent over 26% of the

[4] See *FCC Adopts New Rules for Network Unbundling Obligations of Incumbent Local Phone Carriers*, FCC Public Notice, (rel. December 15, 2004).
[5] *Id.*
[6] *Id.* Rates for UNE-P will be based on "the higher of (1) the rate at which the requesting carrier leased that combination of elements on June 15, 2004, plus one dollar, or (2) the rate the state public utility commission establishes, if any, between June 16, 2004, and the effective date of this Order, for this combination of elements, plus one dollar."
[7] Calculated from the data in the December 2004 Competition Report, table 4. 17,136,000 UNEs with switching / 21,429,000 total UNEs = 80%.
[8] December 2004 Local Competition report, table 10.

competitive LEC access lines in Arizona.[9] Clearly, significant numbers of competitive LEC access lines and customers have been impacted by the FCC's recent actions.

Q. Will the FCC's December 15th decision concerning future UNE availability and prices have any other implications for the level of competition?

A. Yes. Based on information in the FCC's December 15, 2004 Public Notice, in certain markets high capacity unbundled loops (DS-1 and DS-3 levels) will no longer be available at TELRIC rates. In the markets where impairment still exists and unbundled high capacity loops are still available, the rates will increase by at least 15% in most cases. Therefore, many customers will likely experience a combination of fewer options for local telephone service and higher prices.

Q. Does Qwest offer an alternative for the UNE-P?

A. Not really. Mr. Teitzel mentioned that Qwest has offered a commercial product, the Qwest Platform Plus ("QPP") as a replacement for competitive LECs which would prefer to still use Qwest's switching facilities.[10] However, the QPP is not priced using TELRIC based rates and, as the following tables shows, will cost competitors more.

Existing UNE-P Costs[11]

Component	Zone 1	Zone 2	Zone 3
UNE Loop	$ 9.05	$14.84	$36.44
UNE Line Port	$ 2.44	$ 2.44	$ 2.44
UNE Local Usage[12]	$ 0.79	$ 0.79	$ 0.79

[9] Calculated from data in the December 2004 Competition Report, tables 4 and 8. 214,121 competitive LEC lines with UNE-P or UNE switching / 814,194 total competitive LEC lines = 26.29%.
[10] See *Rebuttal Testimony of David L. Teitzel,* December 20, 2004, page 52.
[11] See *Qwest Statement of Generally Acceptable Terms* ("SGAT")
[12] The local usage and shared transport revenue per line is based on the average number of minutes per month per line developed from Qwest's responses to Cox Request 2-23 and 2-24. Qwest reported **{begin proprietary}{end proprietary}** calls per month for residential lines and **{begin proprietary}{end proprietary}** calls per month for business lines. Qwest reported **{begin proprietary}{end proprietary}** minutes per call for residential lines and **{begin proprietary}{end proprietary}** minutes per call for business lines. These amounts result in **{begin**

UNE Shared Transport	$ 0.67	$ 0.67	$ 0.67
Total	$12.95	$18.74	$40.34

Qwest Platform Plus Costs (2005) [13]

Component	Zone 1	Zone 2	Zone 3
UNE Loop	$ 9.05	$14.84	$36.44
QPP Line Port	$ 4.00	$ 4.00	$ 4.00
UNE Local Usage[14]	$ 0.79	$ 0.79	$ 0.79
UNE Shared Transport	$ 0.67	$ 0.67	$ 0.67
Total	$14.51	$20.30	$41.90
% Increase over UNE-P	12.05%	8.32%	3.87%

Qwest Platform Plus Costs (2007) [15]

Component	Zone 1	Zone 2	Zone 3
UNE Loop	$ 9.05	$14.84	$36.44
QPP Line Port	$ 4.84	$ 4.84	$ 4.84
QPP Local Usage[16]	$ 0.79	$ 0.79	$ 0.79

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proprietary}{end proprietary} minutes per month for residential lines and **{begin proprietary}{end proprietary}** minutes per month for business lines. When weighted by the % of residential (**{begin proprietary}{end proprietary}**) and business (**{begin proprietary}{end proprietary}**) access lines in the state, the result is **{begin proprietary} 815.9 {end proprietary}** minutes per month for the average call in Arizona. The percentage of business and residential lines were derived from Qwest's response to Cox Request 2-2.

[13] See *Qwest Statement of Generally Acceptable Terms* ("SGAT") for UNE loop rate and *Qwest Platform Plus (QPP) Rate Sheet – Arizona* for the QPP Line Port, Local Usage and Shared Transport rates.

[14] The local usage and shared transport revenue per line is based on the average number of minutes per month per line developed from Qwest's responses to Cox Request 2-23 and 2-24. Qwest reported **{begin proprietary}{end proprietary}** calls per month for residential lines and **{begin proprietary}{end proprietary}** calls per month for business lines. Qwest reported **{begin proprietary}{end proprietary}** minutes per call for residential lines and **{begin proprietary}{end proprietary}** minutes per call for business lines. These amounts result in **{begin proprietary}{end proprietary}** minutes per month for residential lines and **{begin proprietary}{end proprietary}** minutes per month for business lines. When weighted by the % of residential (**{begin proprietary}{end proprietary}**) and business (**{begin proprietary}{end proprietary}**) access lines in the state, the result is **{begin proprietary}{end proprietary}** minutes per month for the average call in Arizona. The percentage of business and residential lines were derived from Qwest's response to Cox Request 2-2.

[15] See *Qwest Statement of Generally Acceptable Terms* ("SGAT") for UNE loop rate and *Qwest Platform Plus (QPP) Rate Sheet – Arizona* for the QPP Line Port, Local Usage and Shared Transport rates.

[16] The local usage and shared transport revenue per line is based on the average number of minutes per month per line developed from Qwest's responses to Cox Request 2-23 and 2-24. Qwest reported **{begin proprietary}{end proprietary}** calls per month for residential lines and **{begin proprietary}{end proprietary}** calls per month for business lines. Qwest reported **{begin proprietary}{end proprietary}** minutes per call for residential lines and **{begin proprietary}{end proprietary}** minutes per call for business lines. These amounts result in **{begin proprietary}{end proprietary}** minutes per month for residential lines and **{begin proprietary}{end proprietary}** minutes per month for business lines. When weighted by the % of residential (**{begin proprietary}{end proprietary}**) and business (**{begin proprietary}{end proprietary}**) access lines in the state, the result is **{begin**

QPP Shared Transport	$ 0.67	$ 0.67	$ 0.67
Total	$15.35	$21.14	$42.74
% Increase over UNE-P	18.53%	12.81%	5.95%

In all cases, the QPP rates will be higher than Qwest's $13.18 1FR retail rate. Even before the competitor accounts for its own expenses for systems, marketing, accounting, regulatory and legal, etc... the margin will be negative. While some customers may purchase other services such as switch features to provide limited opportunities for some positive margin in zone 1, it is unlikely other sources of revenue will close the gap in zones 2 and 3. In fact, Mr. Teitzel acknowledges the "vast majority" of Qwest's UNE loops are in zone 1 where the "costs are the lowest."[17] Customers in zones 2 and 3 already have fewer opportunities for competitive choice. The elimination of UNE-P and the higher QPP rates will only make the situation more ominous for customers in these two zones. In addition, the **{begin proprietary} 30.1% {end proprietary}**[18] of Qwest retail residential customer lines which have chosen not to purchase any other services such as features will likely not provide attractive opportunities for competitors, and therefore will find few alternatives for basic local service other than Qwest.

Q. Has the real impact of the FCC's recent UNE decision been felt by competitors?

A. No. This decision was just made on December 15, 2004, and the written order has not even been published. The UNE rate increases have not yet been implemented. As noted above, the FCC reported data on the level of competition at the end of June 2004 which showed a significant reduction in competitive LEC growth. As 2005 progresses and the full impact of higher UNE rates (to the extent the UNEs even remain available) is felt by

proprietary}{end proprietary} minutes per month for the average call in Arizona. The percentage of business and residential lines were derived from Qwest's response to Cox Request 2-2.

[17] See *Rebuttal Testimony of David L. Teitzel*, December 20, 2004, page 37.

[18] See Qwest's response to Cox Request No. 4-001.

competitive LECs, further reductions are likely. AT&T has announced it will no longer market residential basic local wireline service nationwide. Mr. Teitzel suggests that there are no facts supporting the potential for a reduction in the level of competition. However, the trends in the FCC's competition reports, the FCC's decision to eliminate UNE-P and the higher QPP prices are completely factual.

Q. On page 52 of his Rebuttal Testimony, Mr. Teitzel suggests the FCC's determination that competitors are not impaired without access to incumbent LEC unbundled switching is a conclusion that competition is flourishing. Do you agree?

A. No. As the analysis of the FCC's December 2004 Competition Report discussed earlier shows, UNE-P is a significant source of competition. In addition the FCC's report showed slowing growth in competitive LEC access lines. While the FCC may have concluded that competitive LECs had adequate alternatives for mass market switching, the FCC could not have concluded that competition was flourishing. The FCC's own report suggests otherwise. In addition, the Staff's analysis of competition in many of the wire centers proposed by Qwest for competitive zone designation shows little evidence of significant competition.[19]

Q. Does the Staff of the Arizona Corporation Commission ("Staff") make any conclusions regarding the level of competition in Arizona?

A. Yes. Staff Witness Armando Fimbres states the following:

> "...the competitive gains in the nearly 9 year window since the 96 Telecom Act was passed highlight slow progress with little support that acceleration is imminent."[20]

Staff Witness Matthew Rowell concludes the following:

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[19] See *Direct Testimony of Matthew Rowell*, November 18, 2004, pages 35-39.
[20] See *Direct Testimony of Armando Fimbres*, November 18, 2004, page i.

> "...the telecom market in Arizona is highly concentrated and that Qwest retains the dominant position."[21]
>
> "However, Staff does not believe that the evidence supports the conclusion that the market is vibrantly competitive and that no consumer protections are needed."[22]

The Staff's conclusions align with my analysis. I agree with Mr. Rowell that the level of competition warrants that consumer protections be adopted as a condition of granting any relief for Qwest from current regulatory requirements. As noted in my direct testimony, should the Commission determine that some form of competitive zone proposal be implemented for Qwest, strict predatory pricing controls and other consumer protections must be included.

Q. Mr. Teitzel continues to suggest that VoIP and wireless service are competitive alternatives to Qwest's wireline service. Do you agree?

A. No. Regarding wireless service, on page 10 of his Rebuttal testimony Mr. Teitzel uses claims that some surveys show some customers are "<u>willing to</u> substitute wireless service for traditional landline service" and "nearly 64% of U.S. households <u>have both</u> a wireless phone and a landline phone." {emphasis added.} Qwest Witness Shooshan suggests the relevant factor is whether "consumers <u>perceive</u> that wireless is a substitute." {Emphasis added.}[23] Customer perceptions, a willingness to substitute service and the presence of both wireless and wireline phones are not the same as replacement.

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[21] See *Direct Testimony of Matthew Rowell*, November 18, 2004, page 31.
[22] *Id.*, page 23.
[23] See *Rebuttal Testimony of Harry M. Shooshan III*, December 20, 2004, page 23.

Mr. Shooshan claims the design of wireless plans to include "'buckets' of minutes that can be used for 'any distance calling'" makes wireless a substitute for basic local service.[24] He also claims that

> "a number of wireless providers are offering free phones and service packages that are far less than $50 and within the range of basic local exchange prices in Arizona."[25]

While these statements may all be true, most wireless service plans, especially the lower cost alternatives, cap the amount of minutes. When usage exceeds the cap, per minute fees of $0.30 to $0.45 usually apply. On the other hand, Qwest's wireline service provides unlimited local calling for a flat $13.18. For many customers, especially POTs customers, wireline service continues to cost significantly less. In addition, wireline service is significantly more reliable; calls are not dropped very often and there is no interference with other services operating on similar frequencies. The fact remains that few customers have actually eliminated wireline service completely as Qwest would like the Commission to believe. The FCC confirmed this conclusion when it wrote the following:

> "… it appears that only a small percent of wireless customers use their wireless phones as their only phone, and that relatively few wireless customers have "cut the cord" in the sense of canceling their subscription to wireline telephone service."[26]

In most cases wireless service is more expensive than and not as reliable as wireline service. However, most wireless customers have made a conscious decision to expend resources on both wireless and wireline service. Thus, customers must view wireless and wireline service as compliments, not substitutes. These characteristics do not make it

[24] *Id.*, page 21.
[25] *Id.*, page 22.
[26] See *Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993*, Federal Communications Commission, FCC-04-216, (rel. September 28, 2004), para 212.

likely that wireline service will be replaced in large numbers in the near future. Mr. Teitzel has clearly overplayed the threat to Qwest from wireless service.

Mr. Teitzel's contentions about VoIP are equally suspicious. He concludes that the number of broadband internet connections in Arizona is growing and cites 536,000 such connections.[27] However, VoIP is a nascent technology still in its infancy. Staff Witness Fimbres concluded that "... the number of VoIP service end-users is very low at this time."[28] As I discussed in my direct testimony, VoIP requires the customer to have a broadband connection which adds to the cost of the service and clearly makes telephone service using VoIP an unreasonable comparison or alternative for Qwest's wireline service, especially for POTS customers. Furthermore, even if all the 536,000 customers with broadband connections mentioned by Mr. Teitzel on page 11 of his rebuttal testimony used VoIP technology for local service, which clearly they do not, this amount would represent less than 16.6% of total Arizona access lines.[29] In fact, VoIP is such a new technology that it is not broadly adopted by consumers and cannot represent a significant fraction of the percentage of total access lines. I agree with Mr. Fimbres that little factual evidence supports VoIP as a competitive alternative to local telephone service at this time.[30]

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[27] See *Rebuttal Testimony of David L. Teitzel*, December 20, 2004, page 11.
[28] See *Direct Testimony of Armando Fimbres*, November 18, 2004, page 36.
[29] The FCC December 2004 Competition Report listed 814,194 competitive LEC and 2,415,432 incumbent LEC access lines for a total of 3,229,626 access lines in Arizona as of the end of June 2004. 536,000 is 16.6% of 3,229,626. Given that carriers serving less than 10,000 access lines are not required to report their access line data, the 3,229,626 amount understates the total number of access lines in the state.
[30] See *Direct Testimony of Armando Fimbres*, November 18, 2004, page 39.

Q. Mr. Teitzel suggests Cox has concluded that DSL is the main reason for Qwest's retail access line loss. Do you agree?

A. No. In my direct testimony I discussed many of the claims that Qwest made about the potential for loss of some of its retail access lines and suggested DSL has been one factor in the reduction of access lines. Qwest additionally claims it faces competition from wireless, VoIP and other sources. My direct testimony merely points out that some of these alleged sources of competition are not comparable to Qwest's wireline service and that the level of competition has consequently been overstated by Qwest. In addition I noted that Qwest's successes in selling DSL would help to offset some of the potential access line lose and the associated revenue impact, if any. DSL provides more revenue for Qwest than a POTs line which will help to alleviate any reductions in revenue from alleged competition whether it is actual competition or not.

Q. On page 54 of his rebuttal testimony Mr. Teitzel claims that "Qwest's wholesale revenue is a small fraction of the total retail value of the end user." Has he looked at the complete impact of a customer moving from retail to wholesale service?

A. No. Mr. Teitzel is correct that the retail relationship can be more favorable to Qwest. However, he only looked at one side of the equation. While Qwest may receive less revenue from a wholesale customer, that gap is at least partially closing as a result of the FCC's new UNE rules discussed earlier. In addition, Qwest incurs less expense to serve a wholesale customer. By focusing on just the historical retail vs wholesale price relationship, Mr. Teitzel fails to provide a complete picture of the financial implications of competition.

Qwest has portrayed severe financial implications of the alleged competitive environment. Mr. Teitzel claims Qwest loses 67% of its revenue when a retail customer is captured by a competitive LEC using Qwest's wholesale service. However, he provides no support for this amount. RUCO Witness Johnson provides a little insight on the true financial implications of competition. Graph 2 on page 90 of RUCO Witness Johnson's direct testimony shows that for the Regional Bell Operating Companies as a whole, costs have actually been lower than revenues since the 1996 Act was passed. While Dr. Johnson's analysis is not specific to Qwest, it does suggest the financial implications of local exchange service competition are not as dire as Qwest claims. Like any other business, there is value in a wholesale relationship. The Commission should not be misled by Qwest's focus on just reductions in its retail revenue, but the Commission should also consider increases in Qwest's wholesale revenue and decreases in its expenses.

E. RESPONSE TO QWEST WITNESS DAVID L. TEITZEL CONCERNING QWEST'S COMPETITIVE ZONE PROPOSAL

Q. On page 51 of his rebuttal testimony, Mr. Teitzel claims Qwest "intends to provide comparable prices to all similarly-situated customers within a competitive zone." Is this suggestion adequate to prevent wide-spread rate de-averaging?

A. No. Not all customers within a competitive zone will be "similar-situated." Therefore, Qwest's proposal could result in numerous rates for the same service within a single competitive zone. In addition, Qwest clearly plans to charge different rates for the same service in different competitive zones across Arizona. Thus, Qwest's proposal will obviously result in wide-spread rate de-averaging in Arizona. In the past, rates have been set by the Commission at uniform levels across the state. Should the Commission ultimately determine some form of competitive zone pricing is appropriate for Qwest, the level of rate de-averaging requested by Qwest would be excessive. Given the potential for competitive zones to be defined by wire centers or a combination of wire centers and zip codes as suggested by Qwest, two similar-situated customers in the same city or town will have different rates for the same service.

Qwest has proposed up to eighty-two competitive zones in this proceeding which could all have multiple sets of rates. Clearly, this arrangement is not in customers' or the Commission's best interest. Cox's proposal to limit Qwest to one set of rates throughout all competitive zones is much more manageable. Contract or individual case base ("ICB") rates could still be used for customers that require unique service packages or pricing to meet a specific product or competitive situation. Customers are going to be confused regardless of how competitive zones are defined, so the Commission should limit the variation in rates as Cox has proposed.

Q. Cox has proposed competitive zones be defined by city or town boundaries. Qwest has suggested wire centers should be used. What determination should the Commission make?

A. Cox has proposed competitive zones be established in a manner which limits customer confusion. Wire centers clearly have no meaning for customers and should not be used to define competitive zones. Qwest may be correct that wire centers help facilitate the measurement and tracking of access lines and network facilities; however, customers do not understand wire centers. Customers do know in which city or town they are located. In addition, local service calling patterns and communities of interest often follow city, town or sometimes county boundaries. Customers will not understand why similarly-situated customers in the same town or city pay different rates for the same telecommunications services. If any plan is to be implemented, the Commission's decision should be based on customer requirements and not network and/or measurement simplicity.

Q. Will Qwest's competitive zone proposal be competitively neutral?

A. No. As Staff Witness Rowell concludes, if the competitive zone proposal as proposed by Qwest is approved, it would have more pricing flexibility than competitive LECs. According to Mr. Rowell,

> "Staff is not aware of any CLEC that has tariffs on file that allow it to price its services differently in each wire center. For the most part, CLECs have statewide tariffs and must charge uniform rates wherever they are serving."[31]

> "Qwest's proposal would give it much more pricing flexibility than Cox currently has."[32]

It clearly makes no sense for Qwest to have more flexibility than its competitors. Should Qwest be granted the ability to price on less than a statewide basis, competitive LECs operating in any region where Qwest has been granted the ability to de-average rates must be automatically afforded the same opportunity without requiring any additional application or Commission action. Clearly, if the Commission determines the level of competition to be adequate enough to allow Qwest to de-average rates, the market must be competitive enough for competitive LECs to do the same. In any competitive zone, at a minimum, competitive LECs must have the same flexibility as Qwest.

Q. Has Qwest made any other proposals which could result in rate de-averaging?

A. Yes. As an alternative to the use of the AUSF for revenue requirement recovery in zones 2 and 3, Mr. Teitzel suggested Qwest would consider a rate de-averaging proposal allowing higher rates in these parts of the state than in zone 1.[33] Under this alternative proposal, Qwest would be able to de-average rates by zone statewide even though many

[31] See *Direct Testimony of Matthew Rowell*, November 18, 2004, page 18.
[32] *Id.*, page 18.
[33] See *Rebuttal Testimony of David L. Teitzel*, December 20, 2004, page 43.

areas of the state might not have been deemed competitive zones. If Qwest is provided this flexibility, all competitive LECs should receive the same opportunity.

Q. On page 54 of his rebuttal testimony Mr. Teitzel dismisses Cox's concerns about predatory pricing by claiming competitors would re-enter the market if Qwest raised prices after driving competitors from the market. How do you respond?

A. Mr. Teitzel has glossed over a critical aspect of Qwest's competitive zone proposal. First of all, as I outlined in detail in my direct testimony, Qwest's prices in competitive zones must be subject to strict price floor controls to prevent it from setting prices below cost and driving competitors out of the market in the first place. Second, Qwest continues to be the dominant carrier and competitors continue to rely on Qwest's network via the purchase of UNEs to compete even though the access to some UNEs has been restricted by recent FCC decisions. As discussed earlier, Qwest will have the ability to de-average rates across the state in competitive zones and even possibly within a single competitive zone. If Qwest is allowed to price below costs in one area, it will have the ability to recover any losses elsewhere in the state. Third, Mr. Teitzel's conclusion that competitors would re-enter the market if Qwest set prices too high is flawed. He fails to recognize the high cost of entry due to the high fixed cost of telecommunications networks and systems that are not easily justified in today's economy, especially in a market where predatory pricing has already been practiced. There has been little dispute in this proceeding about the economic barriers to entry from the high fixed cost nature of the telecommunications business. In fact, Qwest Witness Phillip Grate confirms the high fixed cost nature of the business in the following testimony: "Telephony is a capital intensive and, therefore, a relatively fixed cost business."[34] The Commission cannot assume competitors would rush back into the market if Qwest increased rates. Basic

[34] See *Rebuttal Testimony of Phillip E. Grate*, December 20, 2004, page 3.

common sense, not to mention financial prudence, would make it very difficult to re-enter the market. Cox agrees with the Staff that Qwest has not proposed "specific and clear protections against anti-competitive behavior."[35] In my direct testimony Cox has proposed modifications to Qwest's competitive zone proposal which would help to provide some much needed protections from anti-competitive behavior, assuming competitive zones are adopted in this docket..

Q. Are the Commission's existing rules governing the pricing of competitive services adequate?

A. No. First I find it interesting that Mr. Teitzel mentions the Commission's existing requirement that "the price of a competitive services be set at no less than the TSLRIC of the service,"[36] but does not specifically comment on the price squeeze concerns or the price floor proposal raised by Cox. Qwest is quick to point out the importance of UNEs for competitive entry and the threat to Qwest from such competition, but neglects to consider the importance of UNE rates for establishing a price floor. Existing Commission rules which were established in 1996 do not reflect the realities of today's marketplace. As noted earlier, UNEs are an important source of competitive entry. In my direct testimony I proposed a simple, yet critical price floor requirement for any competitive services and/or zones. The price floor should simply be defined by the sum of the prices of the unbundled network elements that are utilized to provision the service plus the long-run incremental cost of any other required network functions for all competitive services. No evidence has been presented that this proposal would cause a hardship for Qwest or the Commission. In fact, the Commission has already expended considerable effort to establish UNE rates. Those same rates could easily be used to set

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[35] See *Direct Testimony of Matthew Rowell*, November 18, 2004, page 19.
[36] See *Rebuttal Testimony of David L. Teitzel*, December 20, 2004, page 63.

the price floor for competitive services with little additional effort. The Commission's price floor for competitive services should be changed accordingly to eliminate the potential for a wholesale – retail price squeeze on competitors.

F. RESPONSE TO QWEST WITNESSES DAVID L. TEITZEL AND TERESA K. MILLION CONCERNING QWEST'S AUSF PROPOSALS

Q. On page 55 of his rebuttal testimony, Mr. Teitzel dismisses Cox's proposal to modify the funding process for the AUSF as "not appropriate in this proceeding." He suggests the Commission might hold a separate rulemaking on this issue. Is it appropriate for Qwest to increase the size of the AUSF by millions of dollars without an overall examination of the fund itself?

A. No. Qwest's proposal would increase the size of the AUSF significantly. Currently only two carriers draw $841,271 annually from the AUSF.[37] Under Qwest's proposal, the size of the fund would increase by 7700% to over $64 million. Ultimately, this amount will be funded largely from Arizona consumers through increased surcharges on their bills. I find it interesting that Qwest is willing to dramatically change the outflows from the fund without examining the possibility of changing the inflows. Before the Commission approves a change of this magnitude, it should re-examine the overall structure of the AUSF, especially the funding mechanism.

[37] Frontier Communications of the White Mountains receives $769,620 and Midvale Telephone Exchange, Inc receives $71,651. See Decision No. 67456

Q. Ms. Million stated that you calculated Qwest's AUSF funding requirement to be $24.5 million using TSLRIC based costs? Are you proposing Qwest be authorized to draw these funds from the AUSF?

A. No. My calculation was made simply to demonstrate the amount of AUSF which would result from the proper application of the Commission's rules to Qwest's proposal. Ms. Million erroneously used fully-allocated costs to develop Qwest's proposed AUSF draw. The Commission's rules clearly indicate that TSLRIC should be used. I restated Ms. Million's exhibit using the proper cost definition. As noted above, I am not proposing the Commission authorize any AUSF funds to offset Qwest's revenue requirement at this time. At a minimum the AUSF must be restructured before allowing Qwest to receive any funding. In fact, Staff has proposed that Qwest's proposed revenue requirement be reduced significantly and that no AUSF is necessary to provide any incremental revenue.

G. RESPONSE TO QWEST WITNESS TERESA K. MILLION CONCERNING QWEST'S COST STUDY METHODOLOGIES

Q. Ms. Million claims that Qwest based its TSLRIC studies on a UNE costing methodology. Do you agree?

A. Not completely. The methodology may be similar, but the resulting TSLRIC studies cannot be used to establish price floors for competitive services or zones. In addition, while I have not examined Qwest's actual detailed cost studies, Ms. Million's own testimony suggests Qwest's TSLRIC cost studies are not completely based on the UNE costing methodology. On page 13 of her rebuttal testimony, Ms. Million states:

> "Therefore, by using the underlying investments established in the TELRIC docket, and applying <u>retail expense loadings</u> to determine costs Qwest has effectively imputed the UNE costs into its TSLRIC studies." (Emphasis added.)

She admits the Qwest studies are based on retail expense loadings. I am not disputing the use of the investments determined for UNEs in the TELRIC docket in the cost studies in this proceeding. Nor am I disputing the calculation of the TSLRIC studies. However, I am disputing Ms. Million's suggestion that the resulting TSLRIC studies produce the same price floor as UNE costs. Her proposed cost studies do not produce a resulting price floor which equals the sum of the prices of the unbundled network elements that are utilized to provision the service plus the long-run incremental cost of any other required network functions. This is the price floor for competitive service which is required to prevent a price squeeze.

Q. Is Cox disputing the specific TSLRIC cost studies Ms. Million has presented?

A. No. Cox has not taken a position on the calculation of the cost studies themselves. Cox's concern is with the potential application of the studies. Regardless of the underlying investments used in the cost studies, TSLRIC is not an adequate price floor for competitive services. Ms. Million appears to be confusing my concern with Qwest's application of its TSLRIC studies and proposal to use TSLRIC based costs as a price floor for competitive services with the calculation of the cost studies themselves. My only concern is that the proper price floor be established and applied to Qwest's competitive service, and that the price floor be based on the sum of UNE prices, not TSLRIC costs. Even if TSLRIC and TELRIC produced the exact same cost amount as Ms. Million seems to suggest, that cost amount would not be the proper price floor. Competitors pay UNE prices, not TSLRIC costs to purchase network elements.

Q. Should the price floor test apply to just services in competitive zones?

A. No. The price floor must also apply to bundled services to prevent Qwest from avoiding the price floor requirements by bundling non-competitive services, especially basic local services with competitive services.

H. RESPONSE TO STAFF'S COMMENTS CONCERNING QWEST'S COMPETITIVE ZONE PROPOSAL

Q. Staff Witness Rowell has suggested several modifications to the mechanics of Qwest's competitive zone proposal. Does Cox agree with Mr. Rowell's recommendations?

A. For the most part - yes. Many of the changes to Qwest's competitive zone plan proposed by Staff are designed to protect consumers and prevent anti-competitive behavior. As such, I support most of the Staff's proposals and urge the Commission to approve the modifications. However, I would like to comment briefly on two of Staff's proposals – capping basic service rates in competitive zones and the process for identifying competitive zones.

On page 23 of his direct testimony, Staff Witness Rowell proposes that Qwest's rates for basic services in competitive zones be capped at the current rate level. As I discussed at length in my direct testimony, it is likely some of the current rates for basic local services do not exceed their costs as defined by the required imputation test I discussed earlier (or the Commission's existing imputation test as outlined in A.A.C. R14-2-1310 (C)). By definition, if the Commission determines that a zone is to be declared competitive, the market place should be able to protect consumers and control prices. Competition will not succeed in areas where rates are set artificially low by regulation. Cox has proposed that the current rates could serve as transitional rates to prevent any rate shock as prices are aligned with costs and is not opposed to maximum rates. However, as long as the Commission determines rates must be artificially constrained, the market can not really be competitive and there would be no reason to declare it so by designating a competitive zone. Sanctioning Qwest's ability to price below costs and enact a price squeeze on competitors over the long run is not synonymous with competition and not good for consumers.

Mr. Rowell has correctly identified several shortcomings with Qwest's proposals for determining when a geographic area might be competitive. I agree with Mr. Rowell that Qwest should follow the requirements of A.A.C. R14-2-1108(B) when proposing a zone be declared competitive. This rule should be applied to the competitive zones proposed in the proceeding and any requested in the future. If the telecommunications marketplace is changing as quickly as Qwest suggests, automatic designation of additional competitive zones at some point in the unknown future could not be in the public interest.

It does not appear that Qwest has followed this Commission's Rule, and additional analysis is required. In addition, Staff has identified that many of the Qwest wire centers for which competitive zone treatment has been requested do not appear to have significant competitive activity.[38] Based on Staff's analysis, if A.A.C. R14-2-1108(B) is followed, many of the wire centers requested by Qwest for competitive treatment could not be found competitive. Therefore, since important questions remain about the viability of Qwest's plan, Staff's proposal to address the competitive zone issues in a separate proceeding has merit and should be adopted.

[38] See *Direct Testimony of Matthew Rowell*, November 18, 2004, pages 35-39.

Q. Does Cox have any other comments on Staff's recommended imputation test?

A. Yes. As noted earlier, Staff has correctly indicated that Qwest's proposal does not adequately address consumer protections. On page 19 of his direct testimony, Staff Witness Rowell suggests the ability of the Commission to rescind competitive zone classification is an adequate consumer protection on its own. Cox agrees. However, he also mentions that the Commission's imputation rules (AAC R14-2-1310(C)) based on TSLRIC price floors are adequate to prevent anti-competitive pricing. This rule provides a requirement for a price floor based on TSLRIC costs. As noted above and in my direct testimony, a TSLRIC cost based price floor is inadequate as long as UNEs are a significant source of competitive entry, which they are today in Arizona. The Commission should adopt Cox's proposed price floor, which is defined by the sum of the prices of the unbundled network elements that are utilized to provision the service plus the long-run incremental cost of any other required network functions, should be established for all competitive services.

Q. Do you have any other comments about Staff's recommendations?

A. Yes. Staff has reached the same conclusion as Cox about the slow pace of competition and the market dominance of Qwest. Cox agrees with Staff that additional analysis is required before the Commission can approve any specific competitive zone proposal.

I. CONCLUSION

Q. Does this conclude your Surrebuttal Testimony?

A. Yes.